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Supreme Court of the United States.

OCTOBER TERM, 1904.

No. 141.

WINFIELD S. GREGG,
Appellant,

vs.

METROPOLITAN TRUST COMPANY, ET AL.,
Appellees.

Brief on Behalf of Metropolitan Trust Company and F. G. Hallet, et al., Appellees.

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Supreme Court of the United States,

OCTOBER TERM.

No. 141.

WINFIELD S. GREGG,
Petitioner,

vs.

METROPOLITAN TRUST COMPANY ET AL.,
Respondents.

BRIEF ON BEHALF OF THE METROPOLITAN TRUST COMPANY AND F. G. HALLET ET AL., RESPONDENTS.

There are two funds against which the petitioner can claim. There is the fund against which he here claims, namely, the proceeds of the sale of the property. There is also the fund of the Receiver's earnings (Record, pp. 40, 148, 168, 217). By the decree of sale there was to be an accounting of them (Record, pp. 181, 233). This possibility of claiming against two funds is of importance for the reason that if the petitioner's claim against the Receiver's earnings is good, it does not come out of the respondents in any

way. For by the terms of sale, the purchasers received the balance of earnings (Record, p. 21*l*). It would, therefore, come out of them. Whereas if the petitioner's claim here is good against the proceeds, it comes out of the respondents. There are, therefore, three parties interested, namely, the petitioner, the respondents and the purchasers.

The cases in this court allowing the payment of current supply or labor claims divide themselves into four classes as follows:

(a) claims paid out of the earnings of the receivership;

(b) claims which the Court in its discretion may direct its Receiver to pay in order to keep the railroad a going concern;

(c) labor claims; and

(d) claims paid because of a diversion of earnings for the benefit of the bondholders.

Upon this appeal we have nothing to do with class *(a)*. There is nothing before this Court in regard to the earnings of the receivership. Although the decrees and orders intimate that there may have been such earnings, there has as yet been no accounting of the Receiver. It may very well be that the petitioner has a claim against the receiver's earnings.

V. & A. Coal Co. vs. Central Railroad, &c., Co., 170 U. S., 355, 365.

Nor is this a labor claim, class *(c)*.

The petitioner's claim must come, therefore, within either *(b)* or *(d)*.

Parenthetically it should be pointed that out the Sixth Circuit does not stand alone in its interpretation of the opinions of this Court on these points.

Fifth Circuit: In *Cutting vs. Tavarez O. & A. R. Co. (Florida Cent. & P. R. R. Co. interveners)*, 61 Fed. Rep., 150, the Court said, at page 156:

> "*As the court in appointing the receiver made no provision for the payment of such claims and as*

there is no evidence in the record tending to show that current earnings either before or after the receiver was appointed were diverted to paying any unearned interest, or, in fact, any interest upon the bonded debt, we are unable to sanction the order authorizing payment of such claims from the proceeds of the sale of the property. See Fosdick vs. Schall, 99 U. S., 235." (Italics ours.)

SEVENTH CIRCUIT: The Circuit Court of Appeals for the Seventh Circuit, in *Niles Tool Works vs. Louisville N. A. & C. Ry. Co.*, 112 Fed. Rep., 561, cited with approval the decision in *International Trust Company vs. Townsend Brick & Contracting Co.*, 95 Fed. Rep., 850, and also cited with approval from that portion of *Fosdick vs. Schall* bearing upon the diversion point, as follows:

"In Fosdick vs. Schall the doctrine is recognized, as fully exemplified in the later cases, that the mortgagee of a railroad company is entitled to the net income only to be applied in payment of interest or principal of the mortgage indebtedness; that there is an implied agreement that the current income shall be first applied to payment of the necessary operating expenses of the road, and an equitable lien thus arises in favor of debts for current expenses, which will be enforced to displace mortgage liens within reasonable limitations; and, as remarked in International Trust Co. v. T. B. Townsend Brick & Contracting Co., 37 C. C. A., 396, 405; 95 Fed., 850, 859, 'the doctrine thus stated is the foundation of the "diversion" or "restoration" doctrine applied in the later cases.' So the rule which was actually applied in Fosdick v. Schall was in conformity with such doctrine, and, while it is true that remarks in the opinion indicate that 'proper equipment and useful improvements' may be chargeable against the gross earnings, the ground for such possible exception is thus stated:

> 'If, for the convenience of the moment, something is taken from what may not improperly be called the "current debt fund", and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees' 99 U. S., 253; 25 L. Ed., 342."

EIGHTH CIRCUIT: The situation in the Eighth Circuit which the petitioner asserts supports him is at least doubtful. The Circuit Court of Appeals for the Eighth Circuit in *Illinois Trust & Savings Bank vs. Doud, et al.*, 105 Fed. Rep., 123, after reviewing the various cases in this Court, said:

> "When a careful examination and analysis of the facts and opinions in all the cases in the supreme court upon the subject of preferential claims in suits to foreclose mortgages of quasi-public corporations is made, and dicta are distinguished from adjudications, the decisions of that court will be found to sustain these propositions: A mortgagee of the property, acquired and to be acquired, and of the income of a quasi-public corporation, such as a railroad company, obtains a lien upon the net income of the company after the current expenses of operation incurred in the ordinary course of business are paid, and impliedly agrees that the gross income shall be first applied to the payment of these current expenses before the net income to which he is entitled arises. A court of equity engaged in administering mortgaged railroad property under a receivership

in a foreclosure suit may prefer unpaid claims for current expenses of the ordinary operation of the railroad, incurred within a limited time before the receivership, to a prior mortgage lien, in the distribution of the income or of the proceeds of the mortgaged property. If such a mortgagor diverts the current income from the payment of current expenses to the payment of interest on the mortgage debt, or to the improvement of the mortgaged property, so that current expenses remain unpaid when a receiver is appointed, the court may, out of the income accruing during the receivership, restore to the unpaid claims for current expenses the amount so diverted. But if there has been no diversion there can be no restoration, and the amount of restoration cannot exceed the amount of the diversion."

If there is any lack of distinctness in the opinion in Illinois Trust & Bank vs. Doud *(supra)*, *Kansas Loan & Trust Co. vs. Electric R'way, Lt. & Pr. Co.*, 108 Fed. Rep., 702, shows how it is interpreted in that Circuit. The question of diversion was, to be sure, not in point in Illinois Trust & Bank vs. Doud, for the reason that the claim was one for construction and not for current supplies, but in the Kansas Loan & Trust Co. case the case was one of supplies and the question of diversion was, accordingly, important. Judge PHILLIPS said :

"As the intervener's right to a preferential claim is dependent upon the fact that there has been a diversion of the net earnings of the mortgaged property over and above the necessary expenditures for operation, and that such diversion has inured to the benefit of the mortgagees (Bank vs. Doud [C. C. A.], 105 Fed., 123), the burden of proof rests upon the intervener to establish this fact. * * * It devolves upon the intervener to show what sums were diverted after the creation

> of his claim, and he must show by his evidence into what the diverted sum went, so that the court can determine whether it was an improvement or betterment which inured to the benefit of the mortgagee."

The cases cited by the petitioner in that circuit are earlier cases.

In St. Louis Trust Co. vs. Riley, 70 Fed. Rep., 32, cited by him, the question was whether a claim for damages for personal injuries was the sort of a current claim that would be preferred. The Court decided it was not. Much of the language quoted on the petitioner's brief was unnecessary and *obiter*.

We admit that *Central Trust Co. vs. Clark*, 81 Fed. Rep., 269, the other case cited by the petitioner, supports his side, but we respectfully submit that that was decided on the language, which was wholly *obiter* in Trust Co. vs. Riley *(supra)*, and is in effect overruled by Illinois Trust and Savings Bank vs. Doud *(supra)*.

Judge CALDWELL, who dissented in Illinois Trust and Savings Bank vs. Doud *(supra)*, said in that case, at page 153, that the decision of the majority of the Court was in direct conflict with St. Louis Trust Co. vs. Riley, 70 Fed. Rep., 32.

FIRST POINT.

While this Court sometimes may have permitted the payment of a current claim out of the proceeds of sale without proof of diversion, those were exceptional instances. The claim of the petitioners is not such an one. There is no reason why this Court should overrule the discretion of the Court below in omitting to give a preference to this claim.

1. The petitioner relies upon the two cases of *Miltenberger vs. Logansport Railway Company* (106 U. S., 286), and *Union Trust Co. vs. Illinois Midland Co.* (117 U. S., 434).

In *Miltenberger vs. Logansport Railway Co.* (106 U. S., 286), the question did not arise in the same manner as it does here. To be sure, in that case the Receiver was allowed to pay indebtedness to other connecting lines of road in settlement of ticket and freight accounts and balances, and indebtedness for materials and repairs which had accrued prior to the order. But the question was not whether the holders of those claims had a right to have them paid, but whether the Court below in the exercise of its discretion as chancellor could authorize the Receiver to create liens in favor of such claims. All that this Court in effect held was that the Court below had not improperly exercised its discretion in authorizing the Receiver to pay those claims. This may be supported on the ground mentioned in the heading of this point, that the Court had discretion to direct the payment of such a claim in order to keep the concern going. Perhaps the payment of labor claims, where there is no diversion and there is no statutory authority therefor, is to be supported on this ground.

In *Union Trust Co. vs. Illinois Midland Co.* (117 U.

S., 434), the current six months' claim that was allowed was not a claim for supplies, but was a labor claim. These labor claims were combined in the opinion of the Court with some indebtedness due by the Receivers, and consisted of wages due employees of the Illinois Midland Co. within six months immediately preceding the appointment of the first Receiver. The Court, in its opinion, did not discuss at any length the payment of the six months' claims for wages, but after speaking of the claims on account of the Receivers' indebtedness, added:

> "The claims embraced in these items have been carefully scrutinized and reported on favorably by the commissioner and allowed by the Circuit Court, within and in accordance with the principles above laid down, and we think that all of them, including the six months' labor claims,"

were properly allowed. The case, therefore, so far as the claim of the petitioner in the case at bar is concerned, is authority only for the proposition that the Court will make an exception of labor claims and not require proof of diversion before directing their payment. It establishes labor claims as a separate class (see class *(c), supra).*

2. Much stress is laid by the petitioner upon the point that, inasmuch as the payment of six months' labor claims was made in the case at bar, then equally ought his six months' claims for supplies to receive preferential payment.

Is there any basis for his claim under the receivership order? There is not. The petitioner's claim was not provided for in the order in which the Receiver was appointed and by which the borrowing of $35,000 was also authorized. That order (Record, pp. 22–25) read:

> "That as such receiver he have authority * * * to pay the employees, officials and other persons

having claims for wages, services, materials and supplies due and to become due and unpaid, growing out of the operation of the railroad of the defendant, including current and unpaid vouchers; * * * to pay any and all obligations accrued or accruing upon any equipment trusts made by the defendant Railroad Company; and for such purpose, as well as for the purpose of meeting the obligations of the payrolls, said receiver is hereby authorized in his discretion to borrow such sums of money as may be necessary for such purpose, not exceeding thirty-five thousand dollars. But said receiver will pay no claims against said Railroad Company which have accrued more than six months prior to the date of this order."

The $35,000 of Receiver's certificates authorized in the order appointing the Receiver were, therefore, to be used only to pay obligations upon equipment trusts and pay-rolls.

The Receiver next made application for authority to issue $200,000 of Receiver's certificates. In that he said (Record, p. 26):

"there are certain obligations and indebtedness which, prior to the appointment of such receiver herein, said defendant Railroad Company had incurred in the maintenance and operation of said railroad, and which indebtedness it is necessary to pay in order to further operate and maintain said railroad in the performance of its said duties as a common carrier under the law and in the carrying on of its business.

"That said indebtedness is for labor performed by its employees, for maturing and matured car trusts, for traffic balances, for interest on terminal property, for rentals, for taxes, for materials and supplies furnished said Railroad Company and for obligations necessarily incurred in the maintenance and operation of said railroad during a

> period of six months next preceding the appointment of said receiver herein.
>
> "Your petitioner further states that he is unable at this time to state what is exactly the aggregate of such obligations, but that he believes it will exceed the sum of two hundred thousand dollars, and that in order to pay said obligations *or so much thereof as may be necessary*" (italics are ours) "it will require the sum of two hundred thousand dollars within the period of six months next following the appointment of said receiver herein."

The Court made an order in which it referred to the application of the Receiver as one for authority authorizing him to borrow money

> "for the purpose of paying car trusts, maturing or matured, pay rolls, interest on terminal property, traffic balances, taxes and sundry other obligations created in and about the maintenance and operation of said railroad within six months next preceding and following the appointment of a receiver herein,"

and it authorized him

> "to borrow money for the purpose aforesaid in such amount or amounts, not to exceed two hundred thousand dollars, *as he may find necessary*" (italics ours) (Record, pp. 27, 28).

The claims to which the Receiver referred, therefore, exceeded the amount of money for which he asked. He was unable to pay any of them from receipts (Record, p. 26). He, therefore, did not expect to pay all. In fact, he only asked for money to pay such as it should be *necessary to pay*. He apparently did not find it necessary to pay the supply claims.

If there was any merit in the petitioner's contention in regard to the effect of such an order as that appointing the Receiver or authorizing the issuance of

Receiver's certificates, he has failed to assert it at the proper time. He stood by and permitted the making of an application and the issuance of an order which by plain implication might exclude him. Nor has he been injured by the issuance of the Receiver's certificates. For, although they were paid out of the proceeds of the *corpus* of the property, there was left from the proceeds of the sale money sufficient to pay his claim, if it was entitled to be paid, and the expenditures by the Receiver also enabled the Receiver to earn moneys against which the petitioner may still have a claim. Distinct from the provision in regard to this supply claim was the provision in regard to pay-rolls. The payment of pay-rolls was practically made a condition of the appointment of the Receiver. Immediately upon his appointment he was authorized to borrow money to pay them.

It will be seen that Judge TAFT in his order appointing the Receiver and authorizing the issuance of Receiver's certificates followed strictly the law as laid down by this Court in the *Miltenberger* and *Union Trust Co.* cases, and allowed only for the exception that those cases allow.

SECOND POINT.

In order to entitle such a claim as that of the petitioner to payment, the petitioner must prove that current earnings were diverted for the benefit of the mortgage creditors and that there has been no restoration of the diverted fund.

The facts in this case are that there was a diversion. There was also a restoration. The petitioner does not dispute the restoration. He bases his claim on the

broad principle that no proof of diversion is necessary.

The expressions in the cases following the *Miltenberger* and *Union Trust Company* cases are most important.

St. Louis & C. R. R. vs. Cleveland & C. Ry., 125 U. S., 673:

> "By the Court: The rule governing in all these cases was stated by Chief Justice Waite in Burnham vs. Bowen, 111 U. S., 776, 783, as follows: 'That, if current earnings are used for the benefit of mortgage creditors before current expenses are paid, the mortgage security is chargeable in equity with the restoration of the fund which has been thus improperly applied to their use.' There has be no departure from this rule in any of the cases cited; it has been adhered to and reaffirmed in them all."

Kneeland vs. American Loan Co., 136 U. S., 97:

> "Because in a few specified and limited cases this court has declared that unsecured claims were entitled to priority over mortgage debts, an idea seems to have obtained that a court appointing a receiver acquires power to give such preference to any general and unsecured claims. It has been assumed that a court appointing a receiver could rightfully burden the mortgaged property for the payment of any unsecured indebtedness. * * * Can anything be conceived which more thoroughly destroys the sacredness of contract obligations? One holding a mortgage debt upon a railroad has the same right to demand and expect of the court respect for his vested and contracted priority as the holder of a mortgage on a farm or lot. So, when a court appoints a receiver of railroad property, it has no right to make that receiver-

ship conditional on the payment of other than those few unsecured claims which, by the rulings of this court, have been declared to have an equitable priority. No one is bound to sell to a railroad company or to work for it, and whoever has dealings with a company whose property is mortgaged must be assumed to have dealt with it on the faith of its personal responsibility, and not in expectation of subsequently displacing the priority of the mortgage liens. It is the exception and not the rule that such priority of liens can be displaced. We emphasize this fact of the sacredness of contract liens, for the reason that there seems to be growing an idea that the chancellor, in the exercise of his equitable powers, has unlimited discretion in this matter of the displacement of vested liens."

Southern Railway vs. Carnegie Steel Co., 176 U. S., 284:

"By the Court: But it may be safely affirmed, upon the authority of former decisions, that a railroad mortgagee, when accepting his security, impliedly agrees that the current debts of a railroad company contracted in the ordinary course of its business shall be paid out of current receipts before he has any claim upon such income; * * * and that, when current earnings are used for the benefit of mortgage creditors before current expenses are paid, the mortgage security is chargeable in equity with the restoration of any funds thus improperly diverted from their primary use. * * *"

This Court has, it is respectfully submitted, proceeded on the theory that when the earnings are diverted in favor of the bondholders the bondholders receive more than they bargain for and should in equity disgorge or restore the amount that they have

unjustly received. It is akin to the theory of unjust enrichment in quasi-contracts. What sacredness of a contract lien had these prior lien bonds if petitioner's claim is to be permitted ? These bondholders have received 51 per cent. upon their bonds (Record, pp. 324, 330). Such has been the value of their contract lien. The petitioner seeks to receive payment in full. He has endeavored to curry sympathy for himself on the ground that when he furnished the ties in question, in May and June, 1897, the Circuit Court of Appeals had just decided the case of the *Central Trust Co. vs. East Tennessee V. & G. R. Co.*, 80 Fed., 624, and that it was favorable to his contention. But that had not been decided to be the law when in December, 1896, he made his contract to furnish the ties (Record, p. 119), for the *Central Trust Co.* case was not decided until May 4, 1897.

THIRD POINT.

There is no special equity for $3,200.

Granted that the petitioner could have obtained from the Court an order for the redelivery of the ties, which the Receiver used, he did not. Nor did the orders of June 2d and June 7th, appointing the Receiver and authorizing the borrowing of $200,000, direct the payment of his claim. They authorized its payment by the Receiver if the Receiver thought it necessary. Nothing more. It may be that the Court had discretion to direct its payment. If so, the petitioner should have seen to it at the time that it did so. He had five years during which the property continued in the hands of the Receiver, to proceed against him. But he set up the claim which he here does in court after court, and lost in court after court. He cannot complain now.

Of course, he may have a claim against the Receiver on the Receiver's accounting on the ground of the Receiver's use of $3,200 worth of this property. But it is a claim against the Receiver and his earnings, and not against the *corpus* of the property, and is not before this Court.

LAST POINT.

The Decree Below Should be Affirmed.

HERBERT PARSONS,
Of Counsel for Respondents.